Integration of ESG in a disruptive world

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Responsible investing: Will ESG factors disrupt the way you invest?

Our recent quarterly update focused on disruptions — how the current environment can be disrupted by new approaches and technologies. Often disruptors sit in plain sight. The trends and efforts they represent can emerge over time, but ESG factors can also suddenly impact both the way business is done and the value of companies, too.

Disrupters and the disrupted

Talking to our portfolio managers and strategists, it is clear that disruptors are frenemies of investors. On the positive side, investing in early disruptors can sometimes lead to super-normal growth. Whether that's from companies such as Amazon or Google from new technologies such as smartphones, or, from emerging geographies such as China. On the other side of the coin, the disrupted can lose most or all of their value. Take for instance HMV, Kodak, Blockbuster and coal miners, who have all had their businesses devastated by both gradual and sudden disruptions.

We see distinct parallels with considering disruptive influences and with ESG factors — the environmental, social and governance factors within portfolios. These often reflect long-term risks and trends that don't necessarily emerge immediately, but often show up over time, and potentially quite suddenly.

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Environmental disruptors

When it comes to the environment, key themes include the use of carbon in energy production and attention to waste and water utilisation. The global commitments to limit C02 emissions will lead to a transformation impact on energy production and use of fossil fuels. There is potential for significant growth from companies that engage in renewable energy and electric vehicles. On the other hand, we have already seen the negative impact on the coal industry, with coal the least efficient and most vulnerable fossil fuel. Other fossil fuels may follow.

Social disruptors

Social factors include the use of labour as well as weapons and health impacts. The impact of poor labour conditions on customer relationships at companies dates back many years. For example, Nike's supplier's use of Asian factories in the 90s was an increasing brand issue, which it ultimately addressed in early 2000s. Recently, pay equity and representation for female workers has also come to the fore, as well as sexual harassment issues which have arisen from the #metoo campaign. Regarding health, there has been a longstanding focus on tobacco companies as well as more recent attention to food particularly around sugar levels and the welfare of animals used in products.

Governance disruptors

Governance focuses on the quality of the boards, their disclosures, as well as their checks and balances. One of the tests of good governance is the openness and transparency of disclosures from the boards. Improving governance doesn't prevent poor outcomes, but often ensures that companies are more robust and resilient to change. Current governance focuses include the company's awareness of cyber-security risks, its approach to diversity and how it is addressing the requirements from the Taskforce on Climate-related Financial Disclosures (TCFD). Good governance in these areas enable the companies to be better prepared for these potential future disruptions.

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Two ways to assess investment managers

Integrating ESG awareness in to our investment process Within our investment portfolios, we seek to integrate ESG awareness and the evaluation of potential disruptions through understanding the approaches of the managers we select. This occurs within two parts of our manager assessment process: staff and abilities.

Diversity and Inclusion Firstly, with our assessment of a manager's investment staff, we explicitly consider the manager team's Diversity & Inclusion. What matters here is the ability of the team to consider diverse views and understand how other events may disrupt an investment thesis. These team dynamics go much beyond simple framing, such as gender or ethnicity -although diverse membership typically supports diverse thinking. What's more, inclusion is critical: there needs to be distinctive views that are held with conviction. Whilst the team needs to be open to diverse thinking, it also needs to be able to make and retain distinctive decisions.

ESG abilities The second way we integrate ESG awareness is through the direct evaluation of the manager's abilities in our ESG sub-rank. This focuses on the skill of managers to source, analyse and implement ESG understanding within their security evaluation in the context of their overall investment approach. We believe that ESG factors influence security prices and that a deep understanding of ESG influences assists a skilled manager's process. Directly evaluating the managers ESG abilities ensures not only that the evaluation is sufficient, but also helps us evaluate the manager's overall abilities to add value.

ESG evaluation makes investment sense

Understanding ESG capabilities is an important part of evaluating a sound investment process. We can take a lesson from the impacts of disruptors within investments and apply it to considerations of ESG influences. Like more traditional disruptors, ESG factors can present risks that are hiding in plain sight. The rigorous and thoughtful evaluation of ESG influences can help to mitigate these risks within portfolios.

Our responsibility as a signatory of the principles for responsible investment is to encourage all investors to consider ESG influences in their portfolios. We explicitly mandate our managers to consider ESG influences in the portfolios they manage for us. We recommend you do too. For us, this is simply sound investment sense.

Watch Nick join an ESG Masterclass panel for more about how important it is to integrate environmental, social and governance issues when investing.

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